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Discussant's Response to Unique Audit Problems of Small Businesses that Operate under Managerial Dominance

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Baird, Kurtz, & Dobson

Let me say at the outset that this is a comprehensive and useful piece of research on a subject that is most significant to firms such as my own. I was disappointed that Dan offers no specific solutions to the problems precipitated by Sections 320.35 and 320.34 of SAS No. 1 and apparently endorses the recommendations of the Cohen Commission calling for "additional guidance specifically applicable to audits of smaller entities . . ." by the AICPA. Since I have no quarrel with the basic facts presented in the paper, I shall attempt to address these two areas to which I have referred. Let it be understood that the following opinions are my own and do not necessarily reflect the position of my firm on these matters.

Unique Problem

In my opinion, the problem of management override or dominance is not "unique" to the small business. Any objective review of major audit failures will reveal that they are primarily the result of management fraud or misrepresentation. Thus the single greatest audit risk, regardless of the size of the entity under review, may well be the integrity of management or, as I prefer to call it, "Management Bias."

The unique aspect of management override in the small business sector, as defined in the paper, is the relative ease with which management can manipulate the accounting records. It is seldom necessary to resort to "policy writing parties," peer group pressure or other elaborate ruses commonly found to be the causative factors in major audit failures. Due to his "limited financial and accounting experience and capability," the manager of the small enterprise is normally limited to simple misstatement of assets and liabilities.

Since the normal bias of the financially healthy small business is toward minimization of income taxes, the most frequent result is understatement of assets and income. Although the auditor should be as concerned with understatement as overstatement, I think it is fair to state that fewer auditors come to grief for the former than the latter.

Don Ziegler, in his paper presented earlier in this symposium, has offered a succinct and highly perceptive description of the audit attitudes necessary to deal with the risk of management override or fraud:

1. Watch out for overstated assets and understated liabilities.
2. Be wary of related party transactions.
3. Pay particular attention to large, complex transactions.

4. Get to know your client, his business and his industry before you report on his financial statements.

With the exception of Item 3, his formula is as applicable to the small entity as the largest. It should be noted that Don has not attempted to specify which auditing procedures are most effective in achieving his stated objectives.

Management bias must be evaluated on each engagement before meaningful final audit planning can take place. The forces tending to encourage "overstatement" have been discussed many times. At the risk of redundancy, the auditor should be alert to:

1. Significant contemplated borrowing or refinancing.
2. Merger and sale negotiations.
3. Management motivational devices such as:
   a. Budgets and quotas
   b. Incentive compensation
   c. Stock option plans
4. General financial health of entity.

There is an old saying in financial circles; "If a statement is good, it's probably better, and if it's bad, it's probably worse."

The interest of the AICPA in the problem of "management bias" as evidenced by official pronouncements is of relatively recent origin. The following statements on auditing standards pertain to one aspect or another of the problem:

SAS 6	(July, 1975) Related Party Transactions
SAS 12	(January, 1976) Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments
SAS 16	(January, 1977) The Independent Auditor's Responsibility for the Detection of Errors or Irregularities
SAS 17	(January, 1977) Illegal Acts by Clients
SAS 19	(June, 1977) Client Representations
SAS 20	(August, 1977) Required Communications of Weaknesses in Internal Accounting Control

Reliance on Internal Controls in the Small Business Environment

Dan has correctly identified a major problem faced by the auditor of the small enterprise having limited controls, all of which are readily subject to management override. I am sure that we all accept the premise that audits are socially and economically useful. If we accept the capitalist notion that costs and benefits must be kept in a proper relationship, we must constantly challenge any audit procedural requirement that does not contribute in a meaningful way to the process of reaching an informed opinion as to the fairness of presentation of the financial statements under review.

The reliance on internal controls is, in my opinion, the most talked about and least understood of the audit concepts. Prior to 1972, authoritative literature and pronouncements referred to internal controls and internal check. Internal check was defined as, "Procedures designed to safeguard assets against defalcation or other irregularities."

SAP 54 (1972) represented a major effort to re-define the auditor's evaluation of internal control. Among other things, it:

1. Revised and expanded the definition of internal control and introduced four new terms.
   a. Accounting controls—"The plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, the safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing."
   b. Administrative controls—"The plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs and quality controls."
   c. Tests of compliance—Tests designed to provide reasonable assurance that the accounting control procedures are being applied as prescribed.
   d. Substantive tests—Tests of details of transactions and balances and analytical review of significant ratios and trends and resulting investigation of unusual fluctuations and questionable items.
2. Dropped the concept of separate internal check.
3. Described an inverse relationship between reliance on substantive tests and internal accounting controls.
4. Described management override as one of several limitations on the effectiveness of internal accounting controls.

The second standard of field work states that, "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

Frankly, I do not feel that the second standard comprehended the expanded definition of internal accounting controls enunciated in SAP 54. I feel that the auditor is required to acquire an understanding of the client's accounting system. A "proper study" of internal accounting controls (as defined in SAP 54) in circumstances in which the auditor realizes intuitively that such controls do not exist is an absurdity.

There is support for this position in authoritative literature. To paraphrase *Montgomery's Auditing,* 9th edition (The Ronald Press Company, 1975), pages 132 and 133:

> The underlying system has to be understood and the understanding confirmed. Thus a transaction review (walk through) at least is called for in every company being audited . . . the conclusion reached may be . . . to proceed directly to substantive tests because there is not sufficient reason to rely on controls . . . It may be unnecessary to complete an internal control questionnaire, or a special "small business questionnaire" may be useful. Clearly if he already knows he cannot rely on some or all controls, functional tests of those controls serve no purpose.

Our own firm distinguishes between *procedures* (the accounting system itself including the activities of the owner/manager) and *controls* (that which we can rely upon to reduce substantive testing).

In most small business audits substantive tests are performed at the balance sheet date and close attention is paid to cutoff procedures. Engagement partners are chosen for their knowledge of the industry and extensive use is made of analytic procedures. We feel that it is our responsibility to assure that the owner/manager is utilizing procedures to protect his company's assets from employee defalcation and irregularities.

I feel that it would be beneficial to the entire profession if the AICPA would clarify the meaning of "Proper Study and Evaluation of Existing Internal Control."

The Need for Additional Guidance in Auditing Small Business

When the CPA assumed his rightful place among the professionals, he accepted certain responsibilities as well as privileges. Traditionally, responsibility begets authority and with them goes the accountability which no professional person can hope to escape. In the observance of generally accepted auditing standards, the independent auditor must exercise his judgment in determining which auditing procedures are necessary in the circumstances to afford a reasonable basis for his opinion. His judgment is required to be the informed judgment of a qualified professional person.

In my opinion, the standard-setting authorities for any profession should limit themselves, wherever possible, to the enunciation of objective type standards similar in nature to what architects refer to as "performance specifications" as opposed to specific procedural type pronouncements. Official pronouncements were never intended to comprehend a step by step "cook book" approach.

Pressure for the "cook book" approach is brought about by several factors. We live in a litigious society. The class action suit coupled with the adoption of "no fault" insurance laws by most states have unleashed upon the accounting and other professions a great deal of unwanted legal attention. Further, governmental agencies are adopting an aggressive consumer-oriented stance in their dealing with the professionals. In such a climate, it is understandable why professionals of all disciplines should be seeking asylum from these forces.

These pressures, however, must be resisted by professionals in policy-making positions. I have attempted, herein, to enumerate a few reasons for this conclusion:

- Many firms, including my own, tend to accept pronouncements like the "Tablets of Moses."
- Specific procedural pronouncements tend to set a ceiling as well as a floor on standards. Innovation is stifled.
- Specific pronouncements tend to be interpreted legalistically and present problems in interpretation. The three statements on auditing standards cited by Dan Guy as causing concern to auditors of small businesses (SAS 12, 19 and 20) are all of a procedural nature.

If one can equate, in his thinking, the collision of two ships at sea with an audit failure, we might learn something from the experience of the maritime profession in rule making. Rule 2b, "The General Prudential Rule" of the International Navigation Rules, reads as follows:

> "In construing and complying with these Rules due regard shall be had to all dangers of navigation and collision and to any special circumstances, including the limitations of the vessels involved, which may make a departure from these Rules necessary to avoid immediate danger."

Guidance in the application of specific audit procedures to particular situations is essentially a function of education and experience and should appropriately come from the schools of accountancy, the writings of learned men of the profession, and symposiums such as that which we are attending. The ad hoc adoption of standards such as SAS 20 in response to pressure from regulatory bodies or congressional committees must be resisted whenever and wherever possible if the profession is to retain its integrity.